Module Macroeconomics

By Luc Aben
Chief Economist Van Lanschot Kempen

Brief 'historical' overview

Before we start looking to the future, it is useful to look back. This way we can better 'place' and interpret future changes.

One of the most important economic-financial trends in recent decades has been the structurally decreasing trend of inflation and interest rates. The impact on financial markets was very significant. Think of the high valuation of equities or the high returns on bonds.

A brief reconstruction:

- **Inflation rose strongly in the 1970s**. Because of:
    - Years of expansionary fiscal policy. In the post-war period, 'Keynesianism' was the dominant economic movement. It advocates an active fiscal policy to steer the economy: loose in difficult times, restrictive in better ones. In practice, however, policymakers tended to 'forget' the latter.
    - Expansionary monetary policy of central banks. This was possible because of the collapse of the Bretton Woods system in 1971. Under Bretton Woods, exchange rates were fixed. With the dollar directly linked (and redeemable) against gold. *De facto,* this put a brake on money creation and the quantity of money. The quantity of money depended on the quantity of gold. With the collapse of this system, that brake disappeared and monetary policy could be considerably looser.
    - Low confidence in central banks generated high inflation expectations. Which in turn triggered high wage demands and triggered a wage-price spiral. At the expense of the profitability and competitiveness of companies.
    - The oil shock. In 1973, OPEC limited the supply of oil. Resulting in a large price increase.
- Under the impetus of Fed Chairman Paul Volcker, central banks began to raise policy rates from the end of the 70s to fight inflation. This led to an economic recession, but gradually

inflation began to fall. Gradually, financial markets also gained more confidence in the decisiveness of central banks to monitor price stability. Inflation expectations fell.

- **From the second half of the 1980s** onwards, the 'economic paradigm' changed. World leaders such as Ronald Reagan (US) and Margaret Thatcher (UK) advocated small government (in response to Keynesianism), deregulation and market liberalization. Increasing competition helped push inflation lower. The collapse of the Berlin Wall in 1989 symbolized the feeling that capitalism and the free market had finally won over communism.

- Deregulation and liberalization curtailed the power of trade unions. Just as globalization did later on. In addition, the available labour force (baby boomers) peaked. These factors contributed to keeping wage increases (and therefore inflationary pressure) in check.

- **The 1990s** were the years of the ICT revolution which increased productivity. Again inflation-depressing.

- With the introduction of the euro, countries lost the possibility to devalue their currency in order to enhance competitiveness. The subsequent lack of structural reforms in some countries to address this competitiveness, contributed to the euro crisis and the ECB's loose monetary policy (= low interest rates).

- **On December 11th, 2001**, China joined the World Trade Organisation. Through its large reserves of cheap labour, the country became the 'factory hall' of the world. It flooded that world with cheap products. Globalization, which already accelerated in the 1990s, got a further boost.

- The banking crisis (Global Financial Crisis, GFC) and euro crisis threatened to trigger a deflationary spiral from 2007/08 onwards. Central banks responded by sharply lowering policy rates (short-term interest rates), setting up purchase programmes (quantitative easing) and providing cheap financing for banks. The latter with the aim of banks funneling this financing to households and companies through lending. (By the way, this objective was only achieved to a limited extent.)

  This 'cocktail' of measures led to low long term interest rates. Also for weaker countries (e.g.. Italy, Spain, Portugal, ...). The inclusion of corporate bonds in the purchase programmes had a similar effect on the financing conditions of companies.

In different periods of the past decades, different forces were dominant. The common feature is that they all brought both inflation and interest rates to lower levels. To describe these different periods, we propose the following labels:

1980s: "Liberalization"

1990s: "Technolization"

2000s: "Globalization"

2010's: "Monetization"

What forces will dominate post-corona?

- **Central banks** reacted to the corona crisis as they reacted after the banking and euro crisis: lowering policy rates, expanding purchase programmes (QE, quantitative easing) and cheap financing for banks.

- However, in the area of **fiscal policy**, the approach was fundamentally different.

  After the banking crisis, budget deficits and public debt increased sharply in many countries. Partly because of the rescue of financial institutions. However, at the Toronto Summit in 2010, the G20 countries agreed to change course: deficits had to be reduced and debt pushed back. Also, during the euro crisis that followed the banking crisis, the emphasis was on austerity. This was partly due to the fact that the euro area was a currency union with no shared debt responsibility and no rescue mechanisms for countries in financial difficulty.

- Today, the approach is different. There is massive fiscal support for both households/individuals and businesses. "Keynes" is back: an active role for government to revive the economy. By keeping interest rates low, central bank's purchase programmes allow governments to finance that more active role.

  In connection with the latter, there is more and more debate on Modern Monetary Theory (MMT). This is an economic-monetary theory that says that governments of countries with their own currencies can always call on the central bank to 'print money'. Government deficits are therefore always fundable. The core of MMT is that monetary financing is not a problem. In fact, it is an appropriate means of achieving, for example, objectives such as full employment.

When too much 'printed money' would derail inflation, MMT argues to counter this with tax increases.

Strictly speaking, the current purchase programmes are not monetary financing. After all, they work through the secondary market (the market for bonds issued earlier). There is no direct exchange of new bonds for cash between the Treasury and the central bank. But it goes without saying that even the current operations via the secondary market are a *de facto* monetary financing.

- Nevertheless, there is broad consensus among economists that a Keynesian policy is warranted currently. After all, the corona crisis is an external shock that has happened to the whole world. Without any "guilty" party.

  In this aspect, this crisis differs from the GFC or the euro-crisis. These differences were the result of imbalances and excesses in the financial and economic system (excessive debt, fragile financial system, too much risk taking,...). Such crises must be resolved through reforms, by 'sweating out' the imbalances. Often resulting in substantial financial losses. Government's intervention to compensate for these losses raises questions about 'moral hazard'.

- However, despite the consensus among economists, there is a great deal of debate. Not so much about giving this support, but rather about how long it should be maintained?

  There is a camp that advocates rebuilding financial buffers as soon as possible. Another camp advocates that as long as economic growth is not at full capacity, governments should maintain sufficient stimulus. In order to fully exploit the economic potential (an argument that's also emphasized by MMT-supporters). The fact that higher public spending leads to higher budget deficits and rising debt shouldn't be a problem. In the end, this would pay for itself through higher economic growth. Moreover, central banks can keep interest rates low with their quantitative easing.

- How could we view this discussion? Perhaps the next line of thought will be a starting point.

  Not every government expenditure is the same. Some expenditures can be described as government consumption (e.g. social expenditure), but others are rather 'investments' (e.g. infrastructure).

  Large-scale budget deficits mainly due to consumption are at risk of being unsustainable in the longer term. At some point, financial markets may lose confidence and push financing rates sharply higher (at least, if markets can operate "freely", without major impact of sustained interventions by central banks).

  Deficits and debt, on the other hand, because of investments increase the growth potential of an economy in the longer term. If well planned, these will eventually yield both a 'social return' and a 'financial return' (i.e. growth).

  An example of the latter is the creation of the European Recovery Fund. A large proportion of the debts incurred by the European Commission are specifically aimed at investments in the digitization and sustainability of the European economy. The aim is to increase the longer-term growth potential through these paths.

  Where, of course, it's not certain that the desired results will be achieved (e.g. replacing one energy source with another only increases the economic potential if that new (green) source allows working more efficiently). A climate gain is not necessarily the same as an economic gain. Moreover, there is the debate about the extent to which governments should behave as entrepreneurs: are they the most appropriate party to decide on which path to follow towards more productivity?

- The distinction between public consumption and public investment is important. But even apart from that, are we not irresponsibly burdening future generations with debts that they will have to redeem?

  Not necessarily. Governments would rather refinance debt instead of redeem it. Old debts are paid off with new ones. Where there is a danger that this refinancing will have to be done on less favourable terms (higher interest rates). In particular, financial markets rate the financial situation of the country as poor at the time of the refinancing. The level of debt certainly is an important parameter in this judgement.

- Still, it remains to be seen whether this is the most important parameter. Ultimately, a country's "business model" may be more relevant. The extent to which the economy is competitive, dynamic, flexible, etc... If debts are incurred to strengthen a country 's business model or economic resilience, this can contribute to the possibility of refinancing it on good terms in the future.

  After all, in the end, there are 3 ways to control high debt levels:

  - More growth
  - Higher inflation
  - Default

  The first option is by far preferable. If slightly higher inflation is a result of economic growth, this factor can help too (whereas escalating inflation is obviously disruptive and particularly affects savers). Default, in turn, undermines trust in a debtor and thus complicates its future financing conditions.

Central bank independence?

- As pointed out, central banks such as the US Federal Reserve or the European Central Bank significantly boosted their purchases in the event of the corona crisis. In the short term, therefore, the large financing needs of public authorities do not result in higher interest rates. Debt is ‘parked’ on the central bank 's balance sheet.

- This 'interplay' between governments and central banks raises questions about the independence of the central bank. That independence was strongly emphasized from the 1970s onwards. From the Volcker era, in Europe, it was the German Bundesbank that has always placed a strong emphasis on independence. From the periods of hyperinflation in the 1920s and after WW2 onwards. It was following the Bundesbank-model that the ECB was initially set up.

- In the euro area, the European Treaty guarantees the independence of the ECB. That Treaty gives the ECB a single mandate: to strive for price stability. The central bank, in its turn, translates this mandate by aiming for inflation of just under 2%.

Although this mandate seems to be strictly defined, practice shows that it can also be implemented in a (much) more flexible way. For example, the ECB seized on the quantitative easing instrument both in euro crisis and in response to Covid-19 . With the aim of keeping long-term interest rates low.

Quantitative easing can be interpreted as a policy that strives for a certain level of inflation. After all, too high an interest rate is hampering economic dynamism, which would make it more difficult to achieve the 2% target. However, there is the criticism that the ECB interprets its mandate very (too?) broadly. With some suspicion that the real objective of the policy is just to keep interest levels low throughout the euro area. Also, in countries where the credit risk would warrant a higher level (a higher risk premium).

In any case, monetary financing is explicitly prohibited by the Treaty. Monetary financing means that governments sell new bonds/debts directly to the central bank. That's not happening right now. The ECB only buys bonds that are already circulating on the market (the secondary market).

- However, the question is whether this *de facto* does not amount to the same. In the end, the result is that governments can accumulate deficits and build up debts which, albeit through the detour of the secondary market, still end up on the ECB balance sheet.

  Technically, there is also no limit to this mechanism. In theory, it can go on indefinitely. The ECB can 'create' an infinite amount of 'money' at the touch of a button (the so-called 'basic money': notes & coins in circulation and reserves on the reserve accounts held by financial institutions at the central bank). The purchase programmes run through the latter: the bond is on the asset side of the ECB balance sheet, and on the liabilities side the 'new money' is credited to the account of the selling financial institution.
- Ageing: the retirement age means a fall in income, so less spending space. Less demand in the economy means less inflationary pressures.

On the way to post-corona inflation?

From the start of quantitative easing programmes following the banking and euro crisis, there have been fears that inflation would escalate. That hasn't happened so far. Inflation in the US and Europe has remained subdued. In recent years, the concern has been too low inflation rather than too high. Various forces explain this, among other things:

- Digitization: in many sectors, traditional business models are shaken up by digitization. A concrete example is the music sector. Digital streaming services provide access to an almost unlimited offering. For the monthly price of one CD previously.

- Globalisation: globalisation and the ever-increasing liberalization of international trade allow companies to produce where it is cheapest.

  (On the other hand, we should mention that the final impact of an ageing population on inflation can be doubled. For example, a shortage of people of working age can eventually push wages higher. So the reverse effect of what we described earlier in the 1980s, when the labour force peaked. Ageing can also lead to higher prices in certain segments of the economy. Think of the health sector.)

- Decreased velocity of money. The massive monetary support from central banks after the GFC only partially flowed towards the real economy and lending. Many resources remained 'lingering' in the financial system and mainly caused 'inflation' in financial markets.

In the future, other factors could lead to higher inflation:

- Too much liquidity in relation to the production capacity of the economy. Liquidity that is 'supplied' en masse by both a broad monetary policy and fiscal policy.

  There is a risk that 'too much' money will chase 'too few' products. That demand in the economy is getting bigger than the supply side of the economy can deliver. Consequence: inflation.

  This may occur, for example, if a loose fiscal policy focuses on the lower and middle incomes (lower taxes, higher benefits, higher wages,...). These groups are more inclined to spend any additional income.

In this context, it is interesting to look at the US in the coming months. Various Covid-related fiscal support packages included direct financial support for households (cheques, temporarily extended unemployment support). Combined with the restrictions to spend that money, this led to an exceptional increase in Americans' savings accounts. Cumulative to an amount of about 8% of GDP. What will happen if the economy can reopen completely? A tsunami of pent-up demand? What happens to inflation then? And how long will any effect on inflation last?

- Loss of confidence in the value of the money and the monetary system. 'Trust' is the most important pillar of our money system.

  When commercial banks create money, they do so through lending. To grant the credit, the bank looks at the borrower's 'revenue model': will it generate enough income to eventually

  redeem the loan? For example, behind an investment loan for a company, there is an investment. An economic activity with an expected positive return to meet the financial obligations.
  Banks can also ask for guarantees. For instance with a mortgage: behind this is the earning capacity of the borrower, but also the guarantee of a concrete asset.

  However, if the central bank creates basic money, it happens as a kind of 'deus ex machina'. Without a certain 'project' or economic activity behind it. MMT-inspired policies can put an additional 'turbo' on this kind of activist policies of central banks.

  Therefore, society or financial markets can lose confidence in that money. The confidence that the money is worth anything at all. Another word for this: inflation.

  It is by the way this kind of reasoning that resonates with buyers of cryptocurrencies such as bitcoin. They are attracted by the scarcity that bitcoin by definition offers: there is a maximum on the potential issue.

- Deglobalization. Globalization led to the internationalisation of production and supply chains. The corona crisis has shown that these chains can be vulnerable. In the winter of 2020, for example, lockdowns in China led to a shortage of components for production elsewhere in the world.

  In addition, production elsewhere makes countries/regions vulnerable to protectionist measures. Think of countries' tendency to restrict the export of protective clothing or medicines.

In recent years, the political climate turned increasingly against ever-increasing globalization. In the US, for instance, it wasn't just Trump who set a protectionist agenda. Biden is also strongly committed to "Buy American." For example, in the case of purchases by public administrations. They are even allowed to pay up to 20% more for their purchases than the prevailing market price when it comes to a U.S. product.

Post-corona there is an increasing possibility that countries/economic blocs (such as the EU) or companies want to focus more heavily on production within their own borders. For the sake of caution (e.g. having more control over the availability of medicines or supply lines), or for political reasons (think of the US-China trade war unleashed under Trump or the shielding of technology). If the ‘’cost of production” weighs less heavily in future strategic decisions, this can have a direct upward effect on inflation.

Moreover, there is a potential indirect effect. Globalization stimulates the dissemination of knowledge, of technology. By sharing that knowledge or because more international competition forces companies to continue to innovate.

Deglobalization has an inverse effect. Know-how spreads less quickly or there is less 'need' to keep innovating. All this means less efficiency and therefore a higher production cost. Once again, this could push inflation higher.

- Climate risk/energy transition. Carbon taxes or the complete replacement of fossil infrastructure with a sustainable infrastructure are potentially inflationary. In addition, climate change itself can also be inflationary if, for example, food production declines.

Some 'post-corona questions' for investors

- We've already discussed some forces that determine the future inflation picture. It goes without saying that this inflation picture will become an important investment parameter.

- How can monetary policy be 'normalized' again? Both in terms of policy interest rates and the reduction/reversal of quantitative easing? Central banks have been pumping liquidity into the financial system for some time. Past attempts to gradually withdraw these liquidities led to turbulences on financial markets.

For example, in 2013, then-Fed Chairman Ben Bernanke announced that he wanted to gradually reduce the volumes of the then-purchase programme. Promptly, this led to a sharp jump in bond yields (worldwide).

Scaling back the quantitative easing will be a delicate balancing act, which will have to be carried out very gradually. The question is even whether it is possible to leave it completely *at all*. At least without heavy turbulences on financial markets, or without increasing the financing costs of southern European countries too much. Perhaps the debts that are now on the central bank's balance sheets will (largely) remain there.

- In such a scenario, of further anchoring quantitative easing in the normal tool kit of central banks, the likelihood of significantly higher (long term) interest rates seems to decrease (without excluding it, cfr. infra). Where we define 'significantly higher' long-term interest rates as a level that is persistently at or above the structural growth path of an economy. Traditionally, economists consider interest rates equal to the structural (nominal) growth path of the economy to be the normal level of equilibrium.

  Deliberately and 'artificially' keeping interest rates low to avoid jeopardizing the financing of governments, is labelled 'financial repression'. This has a significant impact on savers and investors (e.g. pension funds) or valuations on financial markets.

- Moreover, there remains the possibility that, despite the active policy of central banks to keep the yield curve low, financial markets will lose confidence. Confidence in the ability of central banks to suppress interest rates, confidence in the value of the money created, confidence in keeping inflation under control. Loss of confidence can still drive the (long) interest rate considerably higher, coupled with a depreciation of the currency.

- If interest rates remain low, the search for yield will continue. For example: from high-quality government bonds to investment grade credits. Or from investment grade credits to high yield bonds.

  This search for yield threatens to lead some investors to an asset allocation that actually no longer fits their risk profile. In addition, the prices of financial assets can be pushed up to levels that do not sufficiently reflect their underlying risks.

- The 'fair value' of assets like real estate, infrastructure or equities comes down to the discounted, current value of future cash flows. Maintaining (relatively) low interest rates has a major impact on this calculation. Valuation parameters ('multiples') such as a 'price-to-earnings ratio' in equities can structurally remain at higher levels than their long-term average.

The flip side of the coin is that a structurally higher price-to-earnings ratio also means that there is little/less room to realize future return from 'multiple expansion'. In essence: fewer opportunities to buy at a low multiple and sell at a higher one. Expected returns go lower.

- Not every sector on equity markets has been affected by corona in the same way. Some even benefited. The technology sector, which benefited from 'work at home' and online shopping, is a clear example. Sectors such as (passenger) transport or recreation were

  obvious victims. As are certain segments of the real estate market. Hotels were empty, among other things. Questions about the future of the office market if we all continue to (partially) work from home are asked aloud.

  The question whether these trends also continue post-corona, is an open one. The answer may have important consequences for sectoral choices in investment.

- Shares in growth sectors (e.g. technology) also benefited from falling/low interest rates. Growth stocks traditionally have higher multiple-valuations and are highly sensitive to interest rates. After all, they count on a strong outlook for their future profit development. And in theory, the value of a stock amounts to the discounted value of these future profits. The lower the interest rate, the higher the outcome of this calculation.

  But this also applies the other way around: rising (real) interest rates make these shares vulnerable, especially given the current pricey valuation.

  The same goes for bonds, real estate, infrastructure, private equity, etc...

- No central bank has a certain level for the exchange rate in its mandate. Nor to keep the exchange rate low in order to stimulate the economy through exports.

  However, there is the possibility that a low exchange rate may be implicitly pursued. With the 'justification' that an overpriced currency pushes inflation down too much through cheaper imports.

  Hence, if a large number of economic blocs/countries (implicitly) pursue a cheap currency. For instance, through quantitative easing, which increases the money supply and lowers interest rates (Think of interest rates as the price of money: the higher supply, the lower the price). This can lead to distortions of the foreign exchange market or increase volatility which will result in economic shocks.

- If deglobalization continues, it could have an impact on inflation, as we discussed. But does this also imply a return to a more regionally-driven asset allocation of portfolios? For example, because economic dynamics diverge between different regions? Or because of regulatory restrictions?

- At the beginning of this text, we described the 1980s as the years of liberalisation.
  For investors, this period also initiated the central place of 'maximum shareholder value': the philosophy that the sole purpose of a company should be to maximize value creation for shareholders. A theory developed by (monetarist) Milton Friedman in 1970.

  In recent years, however, this one-sided focus has been increasingly questioned. Companies need to consider more interests and stakeholders in their policies. Think of the increasing emphasis on ESG, or the internalising of costs companies could ignore up to recently. An example of the latter is a carbon tax, in which the external cost of environmental damage is internalised.

- Both monetary and political authorities played a central role in tackling the corona crisis. There is a real chance that this greater social and economic impact of governments will be maintained even after Covid-19.

  In this context, we have already highlighted MMT. With its potential impact on inflation. Another example is fiscal policy. For example, in past decades we could notice ever-lower corporate tax burdens. Sometimes described as a 'race to the bottom'. With international tax competition to attract business activity through a favourable environment.

  Nowadays, we notice some tendencies for higher business taxes and more international harmonisation. Joe Biden, for example, wants to partially roll back Trump's corporate tax cut. An example of greater harmonisation is the OECD's project to establish an international 'digital tax'. In response to questions surrounding a fair taxation of international digital platforms.

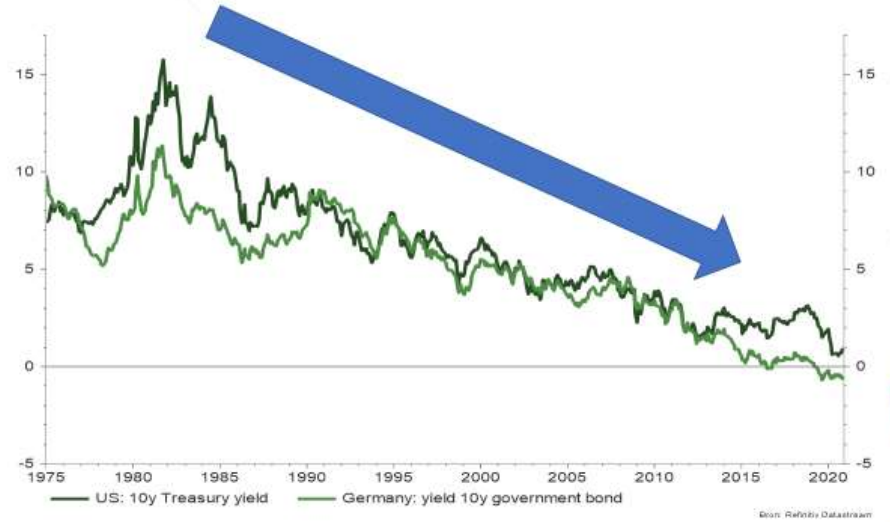
  These trends also fit into the picture of a stronger policy focus on socio-economic populations in the lower or middle regions of society. Think of the cheques that American families received under various Covid-related fiscal packages. Or of the Federal Reserve's adjusted objectives. The Fed explicitly strives for an 'inclusive labour market': a labour market in which as many population groups as possible can participate.

  At the background to these discussions are the concerns about increased inequality.

LT-trend inflation: down

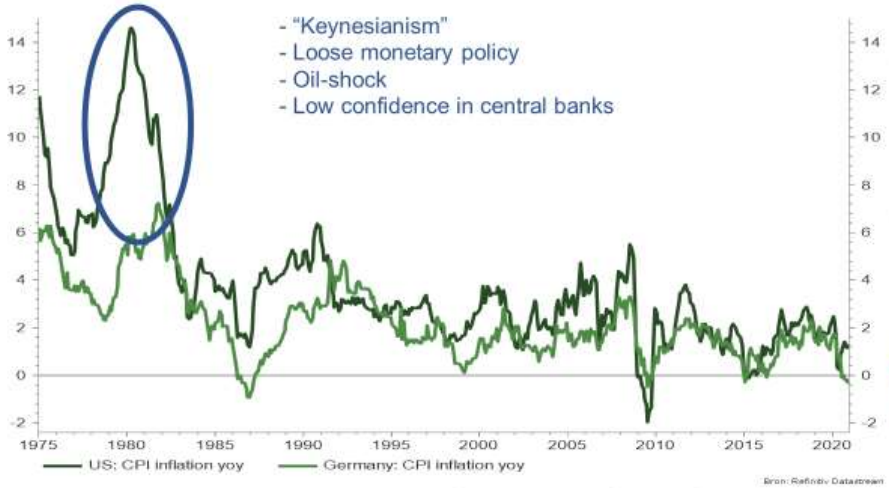
3

LT-trend interest rates: down



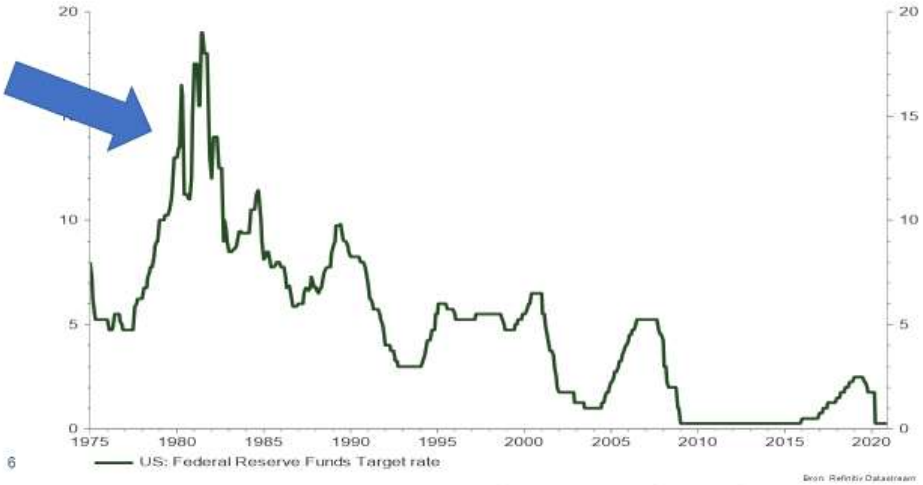
4

70's: inflation soars (especially in US)



5

70s: Federal Reserve to the rescue



6

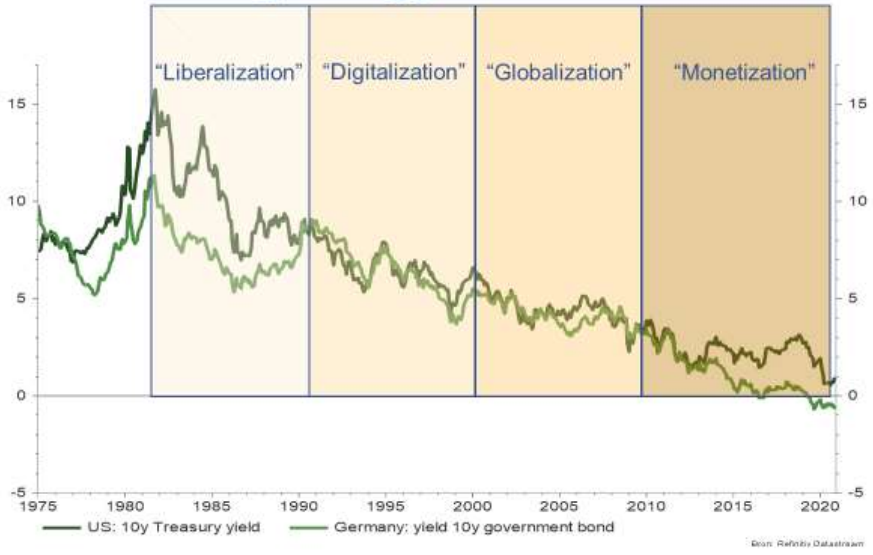
CFA Society Netherlands | vba

Structural changes trigger lower inflation & interest rates

7

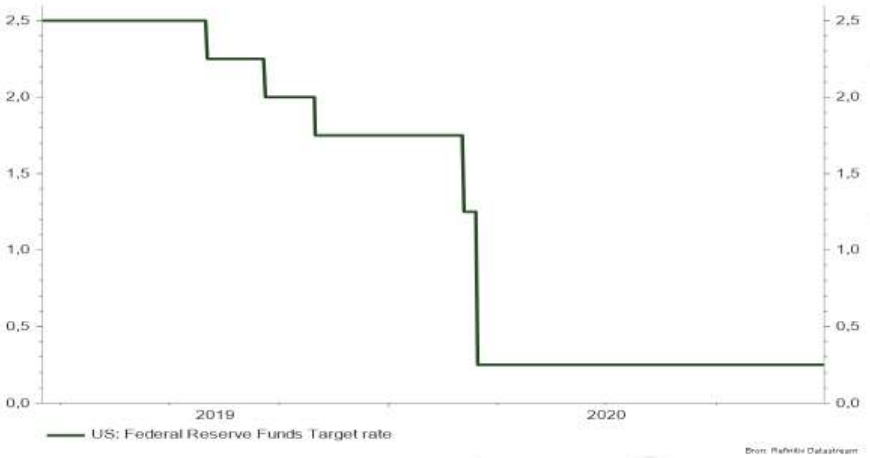
CFA Society Netherlands | vba

Structural changes trigger lower inflation & interest rates



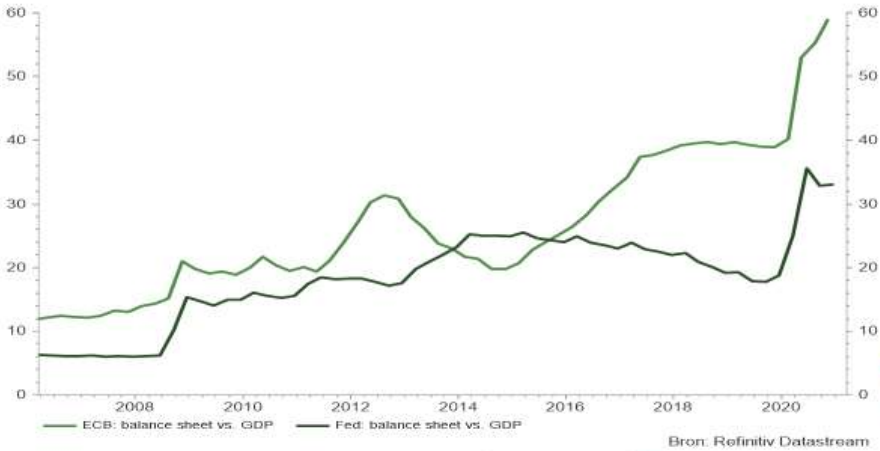
8

Covid-19: central banks lower rates (again)…



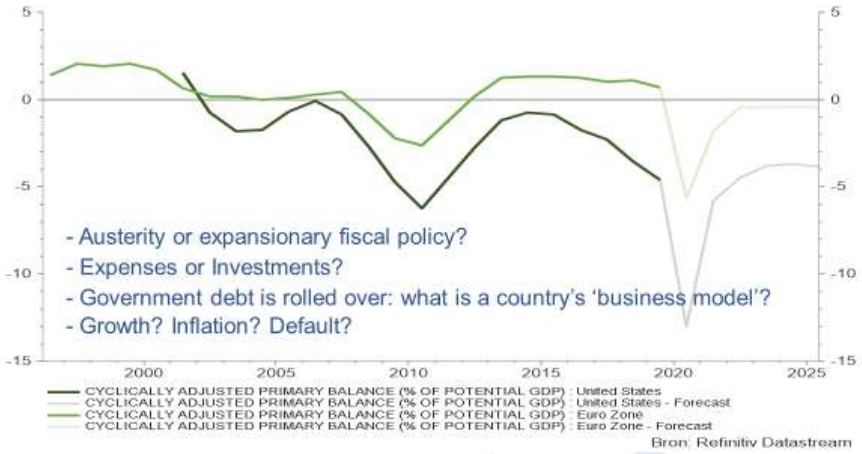
9

… and pump up QE (again)



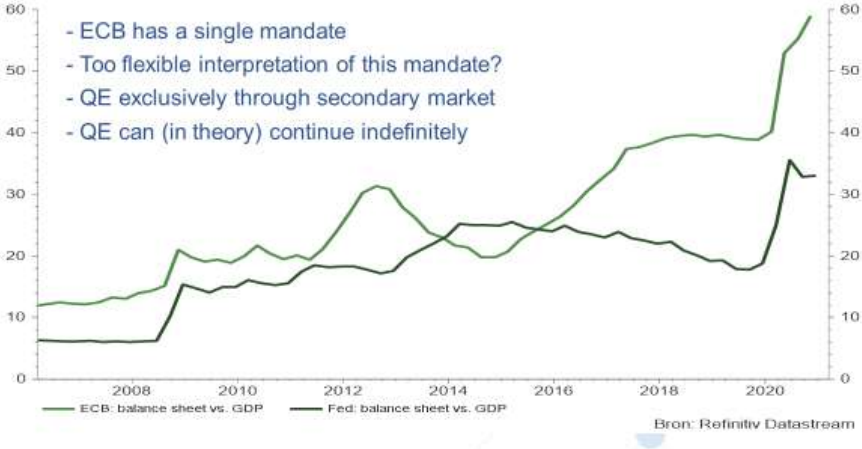
10

Covid-19: fiscal policy jumps in



11

Central banks independent?



12

Low inflation because of…

- … digitization
- … globalization
- … ageing population (although impact on inflation is less clear)
- … decreasing velocity of money

13

Higher inflation caused by…

- … expansionary monetary and fiscal policies?
- … loss of confidence in the monetary system?
- … deglobalization? With direct & indirect effects.

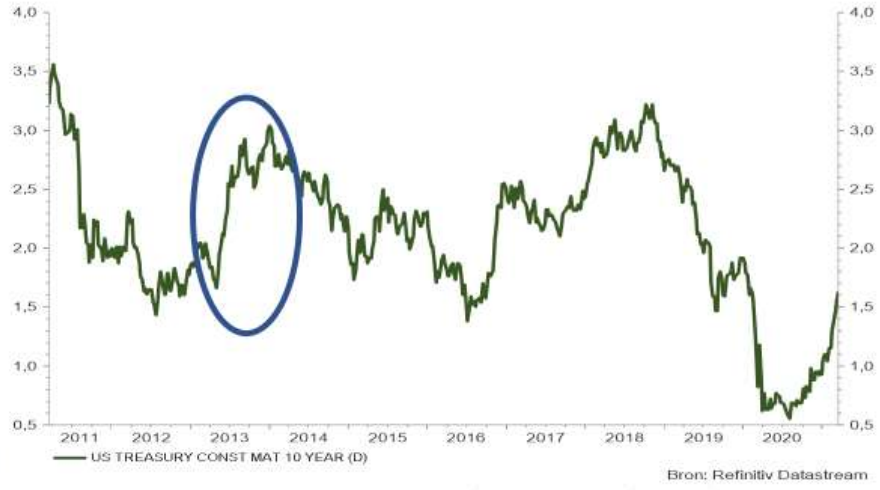
14

Investors have to pay attention to…

- … reflation?
- … 'taper tantrum'?

15

2013: 'Taper-tantrum'



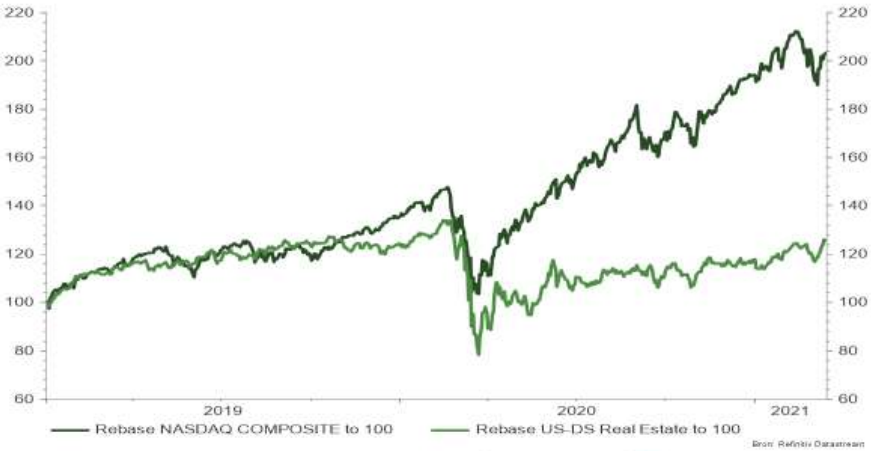
16

Investors have to pay attention to…

- … reflation?
- … 'taper tantrum'?
- … financial repression
- … search for yield
- … expected returns
- … sector choices (re-opening of enonomies, interest rate sensitivity,…)

17

Covid-19: sectoral divergencies



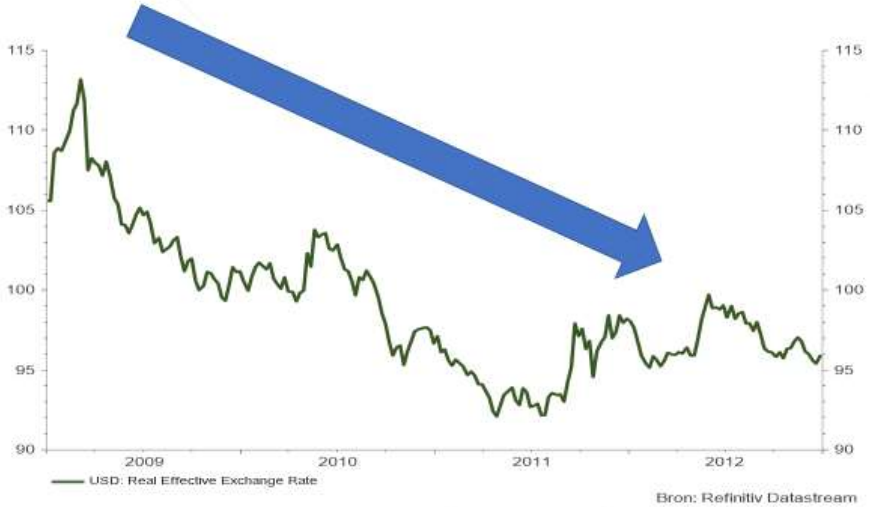
18

Investors have to pay attention to…

- … reflation?
- … 'taper tantrum'?
- … financial repression
- … search for yield
- … expected returns
- … sector choices (re-opening of enonomies, interest rate sensitivity,…)
- … currency markets

19

QE weakens a currency



20

CFA Society Netherlands | vba

Investors have to pay attention to…

- … reflation?
- … 'taper tantrum'?
- … financial repression
- … search for yield
- … expected returns
- … sector choices (re-opening of enonomies, interest rate sensitivity,…)
- … currency markets
- … attention for stakeholders
- … role of policymakers
- …

21